Investec
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Economics

Budget 2019: A little something for everyone

October 9, 2018

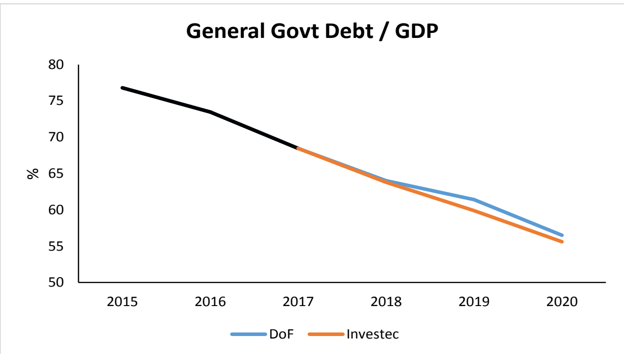
Ireland's Minister for Finance, Paschal Donohoe, today unveiled his second Budget. The backdrop coming into this annual exercise was very favourable. Ireland is poised to be the EU28's fastest growing economy once again this year (we see GDP +7.0%). The White Paper setting out estimated Receipts and Expenditure, released on Friday, showed that absent any policy changes today, the country would run a surplus of €640m (equivalent to 0.2% of GDP) in 2019. While the economic case for an expansionary budget is flimsy (at best), *realpolitik* (the minority government is in a precarious position in the Irish parliament) made it an inevitable outturn.

The EU's fiscal regime limited the net fiscal space to €0.8bn, but in the event the government was able to unveil a €1.1bn package due to a number of revenue-raising measures. The government has modestly reduced income taxes (through a mix of rate decreases and band changes) and provided a broad range of welfare increases, expanded childcare and healthcare supports and targeted additional funding on housing, mental health and the National Treatment Purchase Fund. To defray the cost of this, the government has removed the previous special low (9%) rate of VAT on hotels and restaurants while increasing betting, cigarettes and diesel car taxes.

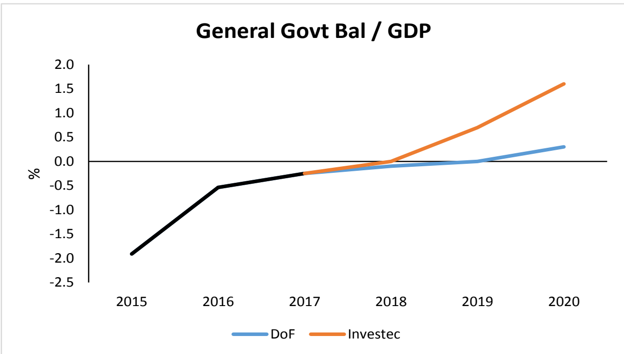
As a result of today's announcements, a General Government Balance of just -€75m is now guided for FY19, equivalent to 0.0% of projected nominal GDP. We currently forecast a surplus of 0.7% of GDP and while today's news imply downside risks to this, we note that the Department has form for providing conservative guidance (more on this anon). One potential area for outperformance is that the projected growth in tax receipts of 5.2% is 100bps lower than the guided increase in nominal GDP – even allowing for the small tax cuts unveiled today this still feels a little light. Headline end-2019 General Government Debt to GDP is guided at 61.4% (Investec: 59.9%), well below the Q113 peak of 124.6%.

In terms of the winners and losers from the Budget, the main beneficiaries are households, due to the income tax cuts and increased welfare supports. The hospitality and leisure sectors will be negatively impacted by the higher VAT rate, although it should be noted that underlying trading is strong, with STR data showing annual RevPAR growth of 9.2% in January-August 2018, so the sector should be able to easily absorb the effect of this increase. Assuming measures to spur housebuilding produce results, this will be good news for building products firms.

We would describe today's announcement as an election Budget, with the modest (equivalent to <0.5% of GDP) package spread very widely. Our view remains that the government will seek a stronger mandate in 2019.



Source: CSO, DoF, Investec



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Budget 2019: Key Observations

- The Minister for Finance and Public Expenditure has unveiled a Budget package totalling a nominal €1.1bn, comprising the €0.8bn of unallocated fiscal space for 2019 detailed in the Summer Economic Statement and €0.3bn from net new revenue raising measures.

- This is the fifth successive expansionary Budget in Ireland. Despite the latest loosening of the fiscal purse-strings, the headline debt and deficit metrics are set to further improve in 2019. The General Government Balance is guided to come in at 0.0% of GDP next year from an expected -0.1% in 2018, while the General Government Debt / GDP ratio is expected to fall to 61.4% by end-2019 from an estimated 64.0% at the end of this year. We think both metrics could outperform.

- The headline General Government Debt / GDP ratio is a key area of focus for investors. However, Irish GDP is distorted by the activities of multinationals with a presence in the State. To this end, two better measures of sustainability are: (i) The ratio of General Government Debt to Tax Revenues; and (ii) The proportion of tax revenues that are eaten up by interest costs. The ratio of Debt / Tax Revenues peaked at 5.7x in 2012 but it is expected to fall to 3.7x this year and improve further to 3.3x by 2020. Helped by Ireland's improved credit standing and the (not unrelated) strong growth seen in recent years, interest costs are expected to equate to 10.6% of tax revenues in 2018, falling to 8.4% by 2020 (the peak was 19.3% in 2013).

- The structural balance is guided at -0.7% in 2019, which is broadly in line with the achievement of the medium term objective (MTO) of a balanced budget, the anchor of the preventative arm of the Stability and Growth Pact. The fiscal space is projected to grow to €2.3bn in Budget 2020.

- The fiscal assumptions behind Budget 2019 look conservative. Tax revenues are projected to increase by 5.2% y/y in 2019, below the 6.2% projected growth in nominal GDP. We note that General Government Expenditures are forecast to grow by 6.0%, skewed towards capital spending where a 23.5% y/y increase in gross fixed capital formation is planned.

- The income tax cuts of €356m (in a full year) equate to only 0.34% of gross household disposable income, so they (along with increased social welfare outlays) will have a modestly positive impact on the outlook for private consumption in Ireland.

- Housing remains the most pressing political issue in Ireland, so it is no surprise to see that the Minister has unveiled an increased allocation of €2.3bn to this area in 2019. Much of this is targeted at the area of social housing, but there are also useful supports for development (both in terms of land and infrastructure provision).

- As had previously been flagged, the government will establish its Rainy Day Fund (essentially, a Sovereign wealth fund), seeding it with €1.5bn from the Ireland Strategic Investment Fund and topped up with an annual contribution of €500m from the Exchequer from 2019 onwards.

- Ireland has a minority government (comprising the centre-right Fine Gael party and a number of independent politicians). By our count the government can expect the support of up to 60 of the 158 TDs (MPs) in the Dáil (lower house), but the passage of the Budget will be ensured if (as expected) the 44 voting TDs attached to the largest opposition party, Fianna Fáil, abstain. The government also has a minority in the Seanad (upper house), but that chamber does not have the power to block money bills such as this Budget.

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The Political Backdrop

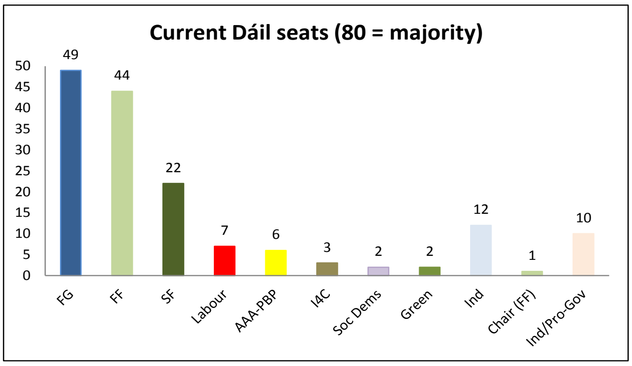
Under the terms of the 'Confidence and Supply' deal under which the largest opposition party, Fianna Fáil, facilitates the minority Fine Gael / Independent administration, three Budgets were to be passed and the deal will be reviewed after the passing of the necessary legislative measures to give effect to the changes announced today.

Ahead of this review, the recent resignation of a government backbencher (Peter Fitzpatrick) who has elected to now sit as an independent TD (MP) provided a timely reminder of the difficult parliamentary arithmetic under which the minority administration operates.

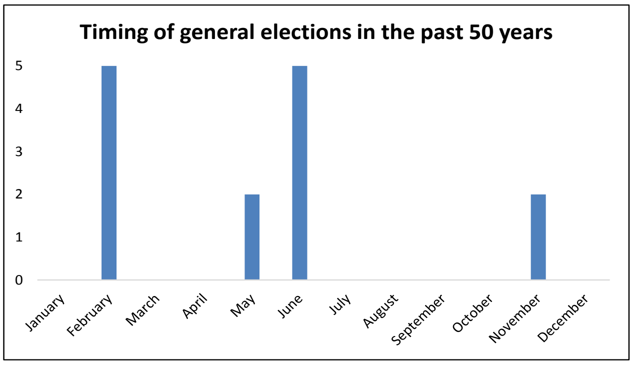
There are 158 seats in the Dáil (lower house of parliament) and of those 49 are held by Fine Gael. It is able to count on the support of the 'Independent Alliance' group of four independent TDs, along with independent Ministers Katherine Zappone and Denis Naughten. A further five independents (Sean Canney, Michael Lowry, Michael Harty, Noel Grealish and – possibly – Peter Fitzpatrick) are likely, but not guaranteed, to support the government in key votes. That gives up to 60 votes.

For Fine Gael, the magic number of votes is 57, which entails the 44 Fianna Fáil members of the house abstaining (so 113 voting TDs, as the Cathaoirleach, or Speaker, does not vote unless in the case of a tie), giving it a slender majority. As we saw with the horse-trading in the run-up to the Budget, relying on a disparate group of independent TDs representing multiple regions and special interests doesn't make for a stable backdrop.

So what are Fine Gael's options? A coalition with Fianna Fáil would provide a commanding majority in the Dáil, but it is not an option that Fianna Fáil, traditionally its biggest rival, would be open to. Opinion polls suggest that Fine Gael would secure 32-33% of the national vote, a meaningful increase on the 26% won in 2016, while its poll lead over second-placed Fianna Fáil ranges from 7-11 points, a safe enough margin to both retain its position as the biggest party and be less beholden to independent politicians. Betting odds from Paddy Power Betfair further showcase Fine Gael's strong position – party leader Leo Varadkar is 1/3 on to retain his position as Taoiseach (Prime Minister) following the next election, while the four potential government formation options with the lowest (i.e. most likely) odds for after the next election all involve Fine Gael (governing on its own at 7/2, governing with independents at 5/1, governing with Sinn Féin also at 5/1 and governing with Fianna Fáil at 13/2).



Source: Investec calculations



Source: Investec calculations

An important consideration, however, is that there are only a few 'windows' in which a General Election is likely to be held. Of the 14 held in the past 50 years, 10 were held in either February or June, with two apiece in May and November. The November polls were 'event driven' (failure to pass a Budget and the fallout from the early 1990s Beef Tribunal). Does this mean a spring election? Unlikely, given Brexit considerations. What then? Local and European elections are scheduled for 24 May 2019. Rather than incur the expense and strain of running separate national campaigns in the same year, might politicians decide to go for an unprecedented 'hat trick' of National, Local and European polls on the same day next year?

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Summary of Today's Taxation Measures

Main Taxation Changes

Measure	**Yield / (cost) 2018**	**Measure**	**Yield / (cost) 2018**
USC		Vehicle Registration Tax	
Changes in bands and rates	*(€105m)*	*Diesel surcharge*	*+€25m*
Income Tax		*VRT relief on hybrid vehicles*	*(€16m)*
Changes in bands and rates	*(€138m)*	*BIK on electric vehicles*	*(€3m)*
Changes in credits	*(€48m)*	VAT	
Excise Duties		*Changes in rates*	*+€460m*
Tobacco products tax	*+€59.4m*	Capital Acquisitions Tax	
Minimum excise duty	*+€2.4m*	*Change in Group A threshold*	*(€6.9m)*
Betting duty	*+€39.5m*	Compliance	
National Training Fund Levy	*+€69m*	*Employer PAYE*	*+€50m*

Source: DoF

We provide more details on today's measures below.

USC

There was no change to the entry threshold to USC, which continues to stand at €13,000.

- The lowest rate has remained at 0.5%. This rate will continue to apply to salaries up to €12,012.
- The 2% rate has also been maintained for 2019 but with a wider band. The 2% rate now applies to incomes in excess of €12,012 but under €19,874, taking the 25 cent increase in the minimum wage into account.
- The 4.5% tax rate will apply to incomes exceeding €19,874 but under €70,044.
- All income above €70,044 will be taxed at 8%.
- Self-employed income over €100,000 will remain liable to a 3% surcharge.

Income Tax

The income tax standard rate band will increase by €750, from €34,550 to €35,300, for all single individuals. The band for married one earner couples will increase from €43,550 to €44,300.

The Home Carer Tax Credit will be increased by €300 bringing the annual credit to €1,500. The Earned Income Credit will also increase by €200, from €1,150 to €1,350.

Excise Duties

The excise duty on a packet of cigarettes will increase once again by 50c (including VAT), with pro-rata increases applied on other tobacco products. This will bring the price of a standard box of cigarettes (20 cigarettes) to €12.70 from midnight tonight. A Minimum Excise Duty on tobacco products will also be introduced at midnight so that all cigarettes sold below €11 will have the same excise charge as those sold above €11. The other 'old reliables' – alcohol and fuel – were left untouched.

Betting duties will increase on all bets placed by customers from 1% to 2% for all bookmakers and from 15% to 25% on the commission earned by betting intermediaries.

VAT

The special 9% VAT rate on the hospitality sector, which was introduced in 2011, will be abolished and a new rate of 13.5% introduced due to the strength of the industry. Newspapers and sporting facilities will be exempt from this change and will remain taxed at the 9% rate. The VAT rate on electronically produced publications will be reduced from 23% to 9%.

Capital Acquisitions Tax

The Group A tax free threshold, which applies to gifts and inheritances from parents to children, will be increased by €10,000 to €320,000.

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Vehicle Registration Tax

A 1% VRT surcharge will be introduced on all diesel engine passenger vehicles registered in the State from 2019.

The VRT relief available on conventional hybrids and plug-in electric hybrids will be extended until the end of 2019.

The 0% Benefit-in-Kind rate for electronic vehicles is also being extended for an additional 3 years, with the €50,000 cap on the Original Market Value of the vehicle remaining in place.

Corporation Tax

The 12.5% rate is being maintained. According to Minister Donohoe the rate is fundamental to maintaining our 'competitive and outward facing business environment', a view we share.

There are two new measures as part of the Anti-Tax Avoidance Directive. An Exit Tax will be introduced, at a rate of 12.5%, on unrealised capital gains in the event that a company migrates or transfers assets offshore. Controlled Foreign Company Rules will also be introduced as required by the ATAD. These new rules will prevent the diversion of profits to offshore entities in low or no-tax jurisdictions.

Stamp Duty

The Young Trained Farmers stamp duty relief will be extended by a further three years to 31/12/2021.

Agritaxation

Farmers will be able to practice income averaging from 2019. This will include the removal of restrictions to farmers with off-farm income and will allow farmers to smoothen their tax liability over a 5 year cycle. Stock relief will also be extended until the end of 2021.

Miscellaneous

The weekly income threshold for the higher rate of employer's PRSI will increase from €376 to €386.
In terms of compliance measures, the new employer PAYE system will be fully operational from 2019.

The National Training Fund levy payable by employers will increase from 0.8% to 0.9%. This rate will be raised further to reach 1% in January 2020.

The Mortgage Interest Relief rate on loans incurred by a landlord will be boosted to 100% in an effort to reduce pressures on the rental market.

The Key Employee Engagement Programme (KEEP) will be introduced in an effort to facilitate the use of share-based remuneration by unquoted SME companies. Gains arising to employees on the exercise of KEEP share options will be liable to Capital Gains Tax on the disposal of shares, in place of Income Tax, USC and PRSI.

The Film Relief scheme which provides a tax credit at a rate of 32% of qualifying expenditure will be extended to 2024.

The Three Year Start-Up Relief scheme will be maintained for a further three years, until the end of 2021.

The Accelerated Capital Allowances for Employer-Provided Fitness and Childcare Facilities will be commenced in January 2019 in an effort to incentivise employers to provide fitness/childcare facilities for their employees.

There will be Accelerated Capital Allowances for Gas-Propelled Vehicles and Refuelling Equipment in an effort to encourage investment in these vehicles and equipment.

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Sector Focus

A number of sectors with representation on the Irish Stock Exchange under our coverage will be impacted by today's Budget and we comment on these below.

Hospitality

As widely anticipated, the reduced VAT rate of 9% on hospitality services that had applied since 2011 will be increased from 1st January with Dalata being the listed stock most impacted by the change. Although an increase had appeared likely since August when the Department of Finance published a review of the impact of the lower rate (and noted that almost €500m in tax revenues were foregone last year as a result), recent speculation had centred on whether the rate would revert to its previous level of 13.5% or be increased to just 11% - and the Minister has opted for a full reversal in this case. The government initially lowered the rate during the depths of the recession to stimulate demand in labour intensive service sectors, but the argument that broad-based economic recovery and strong growth in hotel RevPARs since then have negated the need for special measures for the industry has won out.

In its recent interim results, Dalata noted that full-year group revenues could decline by up to 2% in a full trading year should the VAT rate revert to 13.5%. Management have noted that its contracts technically allow it to recoup the additional cost from customers, but the ultimate impact will depend on its appetite to pass-through the full increase to customers, particularly its corporate and tour clients, we suspect.

Banks

The Irish banking sector appears to have avoided any direct measures in today's Budget, though measures announced in regard to new home construction and buy-to-let mortgage interest relief could have a positive if indirect (and somewhat unquantifiable) impact on the banking sector through additional investment in the broader property sector and accompanying demand for development or residential mortgage credit. Additionally, the €300m Future Growth loan scheme aimed at supporting SMEs and agri-businesses potentially impacted by Brexit may also risk further crowding out of lending to the sector from government-supported credit initiatives.

Food Sector

The only quoted Irish companies with significant exposure to the Irish food and beverage sector and so may be impacted by Irish fiscal policy are C&C and Origin Enterprises.

For C&C, for the second year in a row there is no change to excise duty on alcohol, which is a marginal positive. The tax on sugar sweetened beverages came into force in May 2018 and so was not mentioned in the budget. To recap, the tax relates to sugar added to non-alcoholic drinks and so while C&C does have a soft drinks business it is small and bolt-on in nature and management has not flagged any impact on the business with the tax in place now for five months.

For Origin Enterprises there is nothing in the budget that will have a fundamental impact on the Irish farming sector serviced by the company. The measures announced will probably improve sentiment in the sector, although not markedly. Funding for the Department of Agriculture, Food and the Marine will increase by €57m (up €64m in the 2018 budget) while there is also provision of €60m for Brexit-related supports to improve resilience in the sector (€50m in the 2018 budget). The existing stock relief measures are being renewed for a further three years and there is provision for a three-year extension of the Young Trained Farmer stamp duty relief, which was due to expire at the end of this year. Income averaging is to be extended to farms with off-trade farm income. A further €53m is to be allocated to the first round of projects under the new Rural Regeneration and Development Fund. In addition, funding for the PEACE programme will increase to support economic and social stability in the border region in response to Brexit. Funds will come from an additional €110m that is being divided across a number of government departments.

REITs

This is a neutral Budget from the perspective of the REITs. There were no changes to stamp duty rates on commercial property transactions (unlike last year). While the government has enhanced interest deductibility for landlords, this applies to individuals as opposed to corporates. The Minister also flagged that the upcoming review of Local Property Tax will only result in "moderate and affordable" changes.

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Betting

The government has announced a doubling of turnover tax on sports betting across retail and online in Ireland from 1% to 2%. The betting duty on the commission earned by betting intermediaries or exchanges will increase from 15% to 25%, better than the 30% we had envisaged. The changes will take place from 1 January. We estimate the changes will cost Paddy Power Betfair (PPB) an additional £6m tax in Online (ex-exchange), a further £2.7m of tax on the PPB exchange, and an additional £11.5m of tax in Retail. Overall, this equates to £20.2m or 4.2% of EBITDA. There may be some mitigation of the tax in Retail, however we believe this would be limited.

Housing

Housing remains a red-hot political and social topic but, as the government has already set out the main pillars of its housing strategy in multi-year programmes such as Rebuilding Ireland and the National Development Plan, the announcements as part of Budget 2019 were mainly limited to increased funding for current programmes and restatements of existing objectives. The social housing provision target over the 2016-2021 period, as set out in Rebuilding Ireland, has been increased by 4,000 units to 54,000 with these units to be delivered through acquisition, leasing and direct building. Capital funding of €1.4bn in 2019 has been allocated to this objective. There is also increased funding for housing supports for low income households and, to encourage private landlords to enter/remain in the market, the Minister has increased the amount of mortgage interest relief that landlords can use to offset their tax liability to 100% (this had been due to increase from 80% to 100% by 2021).

Perhaps of greater relevance to private-sector homebuilders, including the listed homebuilders, was what was not mentioned today – the “Help to Buy” scheme. This provides first-time buyers (FTBs) with up to 5% of the cost of a new-build home by way of a tax rebate up to a maximum of €20k and helps FTBs accrue the equity required to purchase a home given that mortgage lending to this segment is capped at 90% in most cases. The scheme is due to expire at the end of 2019 and, in the absence of any official indication of whether the scheme will be extended, there is sure to be considerable speculation on this point over the next 12 months. This may also serve to bring some FTB demand forward into 2019 that might otherwise arise in subsequent years.

Conclusion – A little that goes a long way

That the Minister’s speech ran to 22 pages despite the net tax and expenditure changes totalling the equivalent of less than 0.5% of GDP is a good illustration of the extent to which this Budget involves ‘a little something for everyone’. Given the political backdrop, such a wide dispersal of the fiscal space is understandable.

Of course, we would have preferred to see more precision in the dispersal of the discretionary funds available to the Minister. We do, however, welcome the bias in spending growth towards capital projects (discretionary spending +23.5% y/y to €7.3bn in 2019, versus the 4.1% growth in current expenditure planned for next year). This is largely a function of the National Development Plan.

Income tax (including USC) reductions will, *ceteris paribus*, increase gross household disposable incomes by 0.3%. Lower income earners will also get a modest benefit from the 25c/hour increase (to €9.80) in the minimum wage, while additional childcare supports are also welcome. We note rising chatter from employers about the difficulty in recruiting staff, so the extent to which these measures boost the supply of labour will be closely watched.

Department of Finance - Key Projections

	2018	2019	2020
GDP	7.5%	4.2%	3.6%
Employment Growth	3.0%	2.8%	2.2%
Primary Balance / GDP	1.5%	1.4%	1.6%
General Govt Balance / GDP	-0.1%	0.0%	0.3%
General Govt Debt / GDP	64.0%	61.4%	56.5%

Source: DoF

Investec - Key Projections*

	2018	2019	2020
GDP	7.0%	4.5%	3.8%
Employment Growth	2.8%	2.3%	1.8%
Primary Balance / GDP	3.0%	3.5%	4.1%
General Govt Balance / GDP	0.0%	0.7%	1.6%
General Govt Debt / GDP	63.8%	59.9%	55.6%

*Source: Investec. * = Pre-Budget*

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The Department of Finance now forecasts GDP growth of 7.5% this year, followed by 4.2% and 3.6% in the next two years respectively, which is in-line with our profile of 7.0%, 4.5% and 3.8%. We see government revenue growth more closely tracking GDP than the Department appears to be assuming, which drives the delta between the evolution in the General Government Balance (to a surplus equal to 1.6% of GDP by 2020 on our numbers, compared to the Department's 0.3% forecast). We note that Ireland has a track record of under-promising and over-delivering where fiscal guidance is concerned, so are not particularly troubled by this variance.

DoF Tax Forecasts €m

Heading	Estimated Outturn 2018	Budget Forecast 2019	Change
Income Tax (inc USC)	21,445	22,905	6.8%
VAT	14,090	15,140	7.5%
Corporation Tax	9,605	9,480	-1.3%
Excise	5,620	5,940	5.7%
Stamps	1,575	1,675	6.3%
CGT	945	1,000	5.8%
CAT	470	495	5.3%
Customs	345	365	5.8%
Motor Tax	980	940	-4.1%
Total	55,075	57,940	5.2%

Source: DoF

Moreover, the projected growth in the individual tax headings for looks conservative to us. The 6.8% growth rate in income tax matches the actual outturn for Q1-Q3 2018 and given the strong growth evidenced by the latest employment (+3.4% y/y in Q218) and labour earnings (+3.3% y/y in Q218) data we think the DoF's assumption here should be comfortably met, even taking the modest cuts announced in today's Budget into account.

The 7.5% assumed growth in VAT looks light to us. In cash terms it's an assumed increase in revenues of €1.05bn and around half of this is coming from the removal of the low rate on tourism activities. So the underlying increase here is less than 4%, less than the aggregate increase in household incomes arising from employment and earnings growth in Ireland.

For corporation tax, the 2018 outturn is flattered by timing issues relating to IFRS 15, producing the small annual decrease envisaged in 2019. Given the repeated positive surprises from this heading in recent years, we would not be surprised if the Department's guidance proves conservative again next year.

Excise Duties are expected to grow 5.7% next year. The impact of tobacco duty changes makes this seem reasonable to us, with a similar 'gut feel' applying to Customs. Here we would note that the Department's forecasts assume a Brexit deal is struck (as indeed do our own).

Stamps are expected to increase by 6.3% next year, which looks light given the ongoing strengthening in the Irish property market (for example, the latest house price index release shows annual growth of 8.6%, while transactions should benefit from more new build activity and presumably more churn of the in-place stock). CGT (5.8% growth forecast) and CAT (5.3% growth forecast) seem likely to outperform due to the same dynamics.

Finally, motor tax receipts are expected to fall 4.1% next year. Presumably this is linked to the tepid new car sales market (-4.7% y/y in the year to date) although we suspect that a Brexit deal would lead to sterling strengthening and therefore providing less of an incentive for car buyers to shop around (year to date imports of used cars, nearly all of which come from the UK, stands are +9.2% y/y).

So, all in all our view is that the public finances are more likely to come in at or around our estimates compared to what the Department projects, absent any shocks.

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